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Home Savings and Loan, a Utah Corporation v. The Aetna Casualty and Surety Company : Petition for Rehearing

Utah Supreme Court

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UTAH UTAH SUPREME COURT
DOCKET NO.

IN THE SUPREME COURT, STATE OF UTAH

HOME SAVINGS AND LOAN, a Utah corporation,	*	
Plaintiff/Respondent, and Cross-Appellant,	*	Appeal From Utah Court of Appeals' Decision Dated August 6, 1991 (Case No. 890101-CA)
vs.	*	
THE AETNA CASUALTY AND SURETY COMPANY,	*	
Defendant/Appellant.	*	

PETITION FOR REHEARING OF DENIAL OF CERTIORARI

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IN THE SUPREME COURT, STATE OF UTAH

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INTRODUCTION

This is Aetna Casualty & Surety Company's Petition for Rehearing from the Court's denial of Aetna's Petition for Writ of Certiorari. Rule 35, U.R.App.P. Certiorari was denied by Minute Entry dated February 18, 1992. On March 3, 1992, an extension was granted to file this Petition for Rehearing on or before March 13, 1992. Aetna believes this Court has overlooked key facts and misapprehended important circumstances in its initial consideration of the Petition for Writ of Certiorari. Those facts and circumstances are presented below. This Petition for Rehearing is presented in good faith and not for the purpose or with the intention of causing delay.

POINT I

NEW BOND FORMS DON'T VITIATE THE NEED FOR A PROPER LEGAL APPLICATION OF AETNA'S BOND

Home's opposition to Certiorari is centered on an argument of mootness: i.e., since financial institution bonds have been amended to accomplish exactly the result which Aetna urges under the Standard Form 22 it issued to Home in 1982, there is no need to correct the Court of Appeals' decision. A contrary rationale would not be entertained: i.e., Aetna would not be allowed to argue that since Home failed in 1990 and has been taken over by the Resolution Trust Corporation, judgment should

be reversed because giving favorable treatment to Home's estate serves no useful purpose.

Fairness and a proper legal resolution of a case do not depend on the subsequent (mis)fortunes of the parties or changes in the environment which are outside their control. If anything, subsequent revisions of financial institution bonds to more precisely incorporate the objective "discovery" trigger which has been previously recognized by many courts proves the need to reverse the Court of Appeals. The judgment which Aetna now faces exceeds $2.5 million. Aetna is entitled to a correct legal result for its own sake, in addition to the public need to correct the trial court's and Court of Appeals' strained application of general contract law.

POINT II

AETNA WON AT TRIAL, AND IT IS ENTITLED TO A FAVORABLE JUDGMENT

Aetna won at trial on the discovery of loss issue. The jury decided affirmatively that prior to obtaining Aetna's bond, Home had knowledge of facts which materially affected Aetna's risk. (See Answers to Special Interrogatories 2 and 4, attached at Tab 3 of Aetna's Petition for Writ of Certiorari.) Those facts related to AFCO investor loans and Larry Glad's conduct, which were the overwhelming focuses of evidence at trial. Although both the trial judge and Court of Appeals denied Aetna

relief under Utah's insurance application statute[1] based on this finding, those material facts which Home failed to disclose are the same ones which constitute discovery of loss that triggers coverage under a proper interpretation of the Bond.[2]

Aetna also won at trial on the Section 11 issue. In its brief opposing Certiorari, Home misrepresents that "the jury also found that Home did not learn of Glad's dishonest conduct in connection with the AFCO-investor loans until after the effective [date] of the Aetna Bond." This isn't true. What the jury found was that Home learned of dishonesty by Larry Glad in mid-December 1981 before Glad was terminated (Special Interrogatories 5 and 8); that the dishonesty then learned of occurred while Glad was employed by Home (Special Interrogatory 6); and that this dishonesty first learned of was not directly related to the AFCO investor loans. (Special Interrogatory 7.)[3] This finding of

---

[1]Utah Code Ann. Section 31-19-8 (1974). Aetna is not pursuing its appeal on this issue in the Petition for Writ of Certiori.

[2]Trial Judge Michael Murphy had ruled on summary judgment that, as a matter of law, "[Home] discovered its 'loss sustained' [sic] during the period the Aetna bond was in place." September 21, 1987 Order (R. 385). Therefore, he refused to submit a more direct interrogatory to the jury about when Home discovered the AFCO-related loss, using the accepted definition of discovery urged by Aetna.

[3]The dishonesty first discovered by Home was Glad's receipt of a $15,000 fee from Grant Affleck out of a $100,000 loan which AFCO got directly from Home. When Glad's supervisor, William H. Cox, and its president, Fred Smolka, learned of the secret fee in mid-December 1981, Glad was summarily fired a few days later.

initial discovery of Glad's dishonesty by Home is a far cry from a conclusion that Home did not learn of any AFCO investor-related problems until after June 1982.

Judge Bench correctly understood that these factual findings by the jury triggered coverage for Larry Glad's conduct under the prior bond iss ued by Fidelity & Deposit of Maryland, and it terminated coverage for Glad both for any subsequent conduct as a Home employee and absolutely under any subsequent bond. (See J. Bench dissent at pp. 55-60 of the Court of Appeal's Decision, attached as Tab 1 of Aetna's Petition for Writ of Certiorari.)

POINT III

THE EVIDENCE OF HOME'S DISCOVERY OF LOSS AND ITS DISCOVERY OF LARRY GLAD'S DISHONESTY BEFORE AETNA'S BOND IS CONCLUSIVE

The jury's answers on Special Interrogatories 5, 6, 7, and 8 as to when any dishonesty by Glad was first learned of do not constitute a finding that Glad's dishonesty and the problems on the AFCO investor loans were not known to Home until after Aetna's bond was issued. The evidence is conclusively to the contrary, as indicated in the jury's answers to Special Interrogatories 2 and 4. That evidence includes a letter from Grant Affleck received by Home's president, Fred Smolka, in February 1982 specifically identifying loan irregularities

directed by Glad, Home's loan officer. (See Trial Exhibit 20, attached here at Tab 1.)

The evidence of Home's discovery is even more direct in the AFCO-related complaints filed against Home before June 1982. Home makes light of these complaints in its opposition to the Petition for Certiorari. But they cannot be explained away. The March 1982 Alcorn Complaint (Trial Exhibit 358) names not only Home but also Larry Glad as a specific defendant, and it also alleges the specific lending irregularities which resulted in rescission of the AFCO investor loans in the Armitage Judgment. (See ¶¶ 22 and 23 of Alcorn Complaint, attached here at Tab 2.) Another Complaint against Home in April 1982 (Bott v. Home S&L, Trial Exhibit 356), made almost identical allegations. (See copy of Second Cause of Action, attached here at Tab 3.) So did the Clifford Complaint, also from April 1982. (Trial Exhibit 360.)

In addition, before June 1982 Home had instituted foreclosure actions on all of the AFCO investor loans because they were in default. Home was booking reserves for losses on those loans as noted by its regulator/inspectors. (See Federal Home Loan Bank Board's Report of Examination, Trial Exhibit 196, copy attached here at Tab 4.)

In light of all of this evidence, Home's claim that the jury did not find any knowledge by Home of Glad's dishonesty

related to the AFCO investor loans until after June 1982 is an exercise in conscious ignorance, at best. The jury concluded that Home was aware of material facts relating to the risk from the AFCO-investor loans before Aetna's bond was purchased. (Special Interrogatories 2 and 4.) The majority at the Court of Appeals' misapprehended the legal significance of these facts and jury findings. Judge Bench did not. (See J. Bench's dissent at Point II, Discovery of Loss, pp. 46-58.) Home's attempt to create coverage under Aetna's bond by refusing to acknowledge the reality crashing down around its ears in the first six months of 1982 cannot be condoned.[4]

SUMMARY

Aetna has pared the request for Supreme Court review down to two dispositive legal issues. The legal authorities and analysis of the Bond's text has already been briefed extensively, as highlighted in Aetna's Petition for Writ of Certiori. Judge Bench saw those issues and the controlling precedents clearly, and he dissented forcefully from the majority's effort to cut the

---

[4]Home cannot hide behind documents like its special written promise by the AFCO Investors to repay their loans. (See Trial Exhibits 89 and 90, attached here at Tab 5.) When has any bank ever expected anything else from its borrowers? Home had never used such an extra promise in any loan transaction before or since the special AFCO activity.

pattern to fit the cloth. His opinion could be adopted by this Court without embellishment. The result would be legally correct, and it would be factually consistent with both what the contracting parties agreed to and what the jury intended at the end of trial.

In closing, Aetna recommends a rereading of Judge Bench's dissent, even if just his one-page introduction, a copy of which is attached here at Tab 6. The facts of this case require reversal. The correct application of general contract principles requires reversal. Fairness requires reversal, notwithstanding more recent editions of financial institution bonds.

The objective triggers for coverage under discovery bonds, and the effects of Section 11's termination of coverage provision, are both significant components of financial institution fidelity bonds continuing to the present. Their correct interpretation is a matter of first impression for this State. The issues are squarely presented by this appeal. The law of Utah on this subject should get launched on an even keel, without being skewed by Home's adamant encouragement and the lower courts' strained attempt to justify a result which is

contrary to both the objective intention of the parties and the case law in the rest of the country.

DATED this 12th day of March, 1992.

RICHARDS, BRANDT, MILLER
& NELSON

LYNN S. DAVIES
RUSSELL C. FERICKS
Attorneys for Defendant/
Appellant

rcf\HOME.7

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing instrument was mailed, first-class, postage prepaid, on this 13th day of March, 1992, to the following counsel of record:

Gary R. Howe
P. Bryan Fishburn
CALLISTER, DUNCAN & NEBEKER
800 Kennecott Building
10 East South Temple, #800
Salt Lake City, UT 84133

Gerald Jensen for
Russell C Fericks

Tab 1

Ex 20
Date: Bill Co

AFCO

ENTERPRISES INCORPORATED

February 26, 1982

Home Savings & Loan
Attn: Fred Smolka
116 South Main Street
Salt Lake City, Utah

Dear Mr. Smolka:

Please be advised that under the direction of your loan officer the documents that the individuals signed on Afco's referred 2nd mortgage loans were consumated as follows:

1. The right of recision was waived - all documents were back dated.

2. I was personally instructed to take the documents to the closings to the individuals homes for the closings - without any loan officer or employee of Home Savings & Loan.

We have been assured our transaction with our joint venture lender will be closed within a thrity (30) day period. In such case the 2nd mortgages with your institution as herein referred to will be brought current or paid in full.

It would be my recommendation that you give us the time as indicated (30 days) to consumate our joint venture captial avoiding any direct legal action from individuals that have taken out the above referenced 2nd mortgage loans.

Sincerely,

Grant C. Affleck

GCA/cm

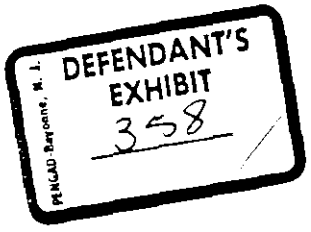
cc: Mr. Bradshaw
Mr. Woodbury Jr.

DEPOSITION EXHIBIT 20-608 Rocky Mountain Reporting Service

EXHIBIT
20

9790 SOUTH SKYE DRIVE · SOUTH JORDAN, UTAH 84065 · TELEPHONE (801) 561-1408

Tab 2



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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF UTAH

Central Division

In re AFCO ENTERPRISES, INC., Debtor.	Bankruptcy No. 82-00577 Chapter 11
In re AFCO DEVELOPMENT CORPORATION, Debtor.	Bankruptcy No. 82-00578 Chapter 11
In re AFCO INVESTMENT CORPORATION, Debtor.	Bankruptcy No. 82-00579 Chapter 11
CURT M. ALCORN and BRENDA S. ALCORN, his wife; CARL J. ALDER and MARY S. ALDER, his wife; HARRY R. ALLEN and GEORGIA L. ALLEN, his wife; WELDON GALE ALLRED and JOAN F. ALLRED, his wife; KENT G. ALLSOP and CELIA KAY ALLSOP, his wife; BORGE B. ANDERSEN; PAUL GARETH ANDERSEN and CAROL S. ANDERSEN, his wife; ROBERT K. ANDERSEN and DONNA W. ANDERSEN, his wife; KENT D. ANDERSON and JUDY A. ANDERSON, his wife; ROBERT E. ANTHON and GAIL P. ANTHON, his wife; GALE B. ARMSTRONG and MARGARET ARMSTRONG, his wife; DR. KARL J. ARMSTRONG; WILLARD G. ATKIN, JR. and BETH WORKMAN ATKIN, his wife; WALLACE A. BAKER and JUNE L. BAKER, his wife; MERRILL R. BARKER and KATHRYN K. BARKER, his wife; DARRELL D. BATEMAN and	Adversary Proceeding No. [illegible] C O M P L A I N T (JURY DEMANDED)

n. Plaintiffs could freely exercise their right of rescission provided by law.

22. During the course of offering and selling the investment packages to Plaintiffs, the Defendants, and each of them, failed to disclose to Plaintiffs, inter alia, the following material facts:

a. AFCO was, at all times, in dire financial circumstances and could not borrow any additional funds from traditional lenders, and had been refused further credit by certain of certain lenders.

b. There was a substantial degree of risk to be borne by Plaintiffs in purchasing the investment packages.

c. The real estate market on which AFCO purportedly relied for a source of funds to repay its obligations was depressed and AFCO had not sold, nor did it have any realistic prospects for the sale of enough properties to pay its obligations to Plaintiffs and others.

d. AFCO could not pay its current obligations without obtaining the funds generated by the investments of Plaintiffs.

e. AFCO would not be able to pay Plaintiffs and the Funding Institutions as agreed unless AFCO received additional money from future investors.

f. AFCO was losing money.

g. The proceeds of Plaintiffs' investments would be used to pay the current debts of AFCO including compensation to Affleck, Shaffer and other officers and employees of AFCO, and obligations to Funding Institutions, other lenders and other investors.

h. The collateral offered by AFCO was insufficient and inadequate to secure the repayment of the AFCO promissory notes in favor or Plaintiffs.

i. The net worth of AFCO was overvalued.

j. The collateral purportedly securing the AFCO promissory notes to Plaintiffs had been previously encumbered to other Plaintiffs or other creditors or investors, and there was no real equity remaining in said real property.

k. The character of prior encumbrances on the property purportedly used as collateral by AFCO to secure repayment of the obligations to Plaintiffs created an inordinate degree of risk for the Plaintiffs.

33. In addition to making or participating in making the foregoing misrepresentations and omissions, the Funding Institutions departed from conventional and standard lending practices, in that, inter alia, said Defendants:

a. Represented that Plaintiffs' transaction with and investment in AFCO was a sound and prudent investment.

b. Expedited the completion of the loan transaction to meet the demands and purposes of AFCO.

c. Established interest at rates negotiated by AFCO.

d. Accepted representations of AFCO as to financial resources and credit worthiness of Plaintiffs without seeking, receiving and/or relying upon independent confirmation from Plaintiffs.

e. Authorized and permitted AFCO to solicit and arrange said transactions on behalf of Funding Institution.

f. Authorized and permitted AFCO to arrange, supervise and control the review and execution of transaction documents.

g. Approved transactions upon AFCO's unconfirmed assurances of its net worth and credit worthiness.

h. Agreed to rely upon AFCO credit for repayment of monies.

i. Ignored the verbal representations of some Plaintiffs that they were unable to repay the advances made by the Funding Institutions.

j. Ignored the apparent inability of some Plaintiffs to make repayment.

k. Failed to provide Plaintiffs an adequate opportunity to rescind.

l. Informed AFCO of the efforts of certain plaintiffs toward rescission of the transactions and discouraged attempts by Plaintiffs to rescind said transactions.

24. Each of the Defendants hereinabove collectively identified as AFCO was the agent of all other AFCO Defendants in the marketing of the investment packages.

25. Each of the Funding Institutions agreed with AFCO to participate in the financing of AFCO through the above-stated scheme.

26. At all times pertinent hereto, AFCO and the Funding Institutions were jointly engaged in the business of marketing the above described investment package.

27. AFCO entered into joint ventures or partnerships with each of the respective Funding Institutions, the activities of which included finding potential buyers and/or investors, consummation of loan transactions and the payment of proceeds to one or more of the joint venturers for the purpose of creating commercial profit for the Funding Institutions and for AFCO.

28. As joint venturers or partners, AFCO and each Funding Institution was the agent of the other in the marketing of the investment packages.

29. The actions, including material misrepresentations and omissions, of the Funding Institutions and Funding Individuals, were both necessary to and a substantial factor in bringing about and effecting the sales of the investment package to Plaintiffs.

Tab 3

DEFENDANT'S EXHIBIT 356

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IN THE FIRST DISTRICT COURT OF BOX ELDER COUNTY

STATE OF UTAH

ARTHUR J. BOTT, SHIRLEY N. BOTT, DAVID A. BOTT, PATRICIA F. BOTT, Plaintiffs, vs. HOME SAVINGS & LOAN, BARCLAYS AMERICAN-FINANCIAL, AFCO LEASING CORPORATION, RICHARD L. GRAY, STEVE N. OLPIN, GRANT C. AFFLECK. CARVEL R. SHAFFER, DAVID N. PINNEY, MARY JO CHRISTENSEN, SANDY WINKLESKY, ROD GOODMAN, MICHAEL D. WRIGHT, RAYMOND C. LAMBERT, TED R. KNODEL, CHRISTOPHER J. THEURER, BMW AUTO LEASING, INC. Defendants.	COMPLAINT Civil No. 17132

Comes now the plaintiffs, Arthur J. Bott, Shirley N. Bott, David A. Bott, and Patricia F. Bott, by and through their attorneys Roger F. Baron and Jon J. Bunderson of Bunderson and Baron, Attorneys at Law, and allege for causes of action against the above referred to defendants as follows:

STATEMENT OF FACTS

That on or about August 27th, 1981, the plaintiffs, Arthur J. Bott and Shirley N. Bott, husband and wife, were contacted by Mr. Steve N. Olpin concerning the purchase by them of certain promissory notes issued by AFCO Enterprises, Inc.. That during that first meeting on August 27th, 1981, the aforesaid Steve N. Olpin did represent to the aforesaid plaintiffs that Elder Paul H. Dunn of the Church of Jesus Christ of Latter Day Saints was on the Board of Directors of AFCO Enterprises, Inc., and that therefore the investment was a sound one. That the aforesaid Steve N. Olpin also told the Botts that the investment which he was proposing was a sure one and would involve no risk to them or their property. Mr. Olpin also told Mr. and Mrs. Bott that the money for the investment could be obtained by AFCO Enterprises, Inc., through the means of Mr. and Mrs. Bott establishing a "line of credit". Mr. Olpin stated that he would arrange for appraisers to look at their house. He picked up copies of Mr. and Mrs. Bott's 1980 tax return forms. After that first meeting, Mr. and Mrs. Bott were contacted by a person unknown at this time and arrangements were made for them to meet with the defendant Grant

Number 17132-1
FILED
MAR 26 1982
By L. Davis

upon reasonable banking credit practices.

6. That as a result of the aforesaid violations of 15 USC 77q and also of the Utah Uniform Securities Act, plaintiffs have experienced extreme mental anguish concerning the losing of their residences, are currently in immediate danger of losing their residences and also those certain vehicles supplied to them by AFCO Enterprises, Inc., have incurred certain personal liabilities in regard to their residences and the automobiles, plaintiffs Arthur J. Bott and Shirley N. Bott have made one mortgage payment in the amount of Eight Hundred Fifty Dollars ($850.00) to Barclays American-Financial, have been forced to obtain legal counsel and incur costs in connection with this Complaint and expect to incur other and further damages as this case proceeds.

SECOND CAUSE OF ACTION

1. Plaintiffs include in this their Second Cause of Action all allegations pertaining thereto made in their First Cause of Action and all other causes of action contained in this Complaint.

2. That with relation to that certain transaction outlined in the Statement of Facts above dealing with plaintiffs David A. Bott and Patricia F. Bott, the aforesaid plaintiffs were provided with a document entitled Notice of Right of Rescission.

3. The aforesaid Notice of Right of Rescission did not conform to either the Utah Consumer Credit Protection Act or the Federal Truth In Lending Act and Regulations as follows:

a. The aforesaid document predated the transaction as November 9th, 1981 whereas the actual transaction took place November 13th, 1981.

b. That the above plaintiffs were not notified of the date by which they could rescind the transaction and in fact, the date of the aforesaid mentioned Right of Rescission is left blank on the copies of the Notice of Right of Rescission given to plaintiffs.

c. That the aforesaid plaintiffs did not receive the four copies required of the Notice of Right of Rescission required by law.

d. The monies concerning the transaction referred to in the Notice of Right of Rescission were disbursed prior to the end of three days following the actual transaction date of November 13th, 1981 contrary to law.

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4. That prior to the filing of this Complaint, the plaintiffs, David A. Bott and Patricia F. Bott, did mail a Notice of Rescission to the defendant, Home Savings and Loan, 130 East 300 South, Salt Lake City, Utah.

5. That pursuant to this notice, plaintiffs, David A. Bott and Patricia F. Bott, are entitled to rescind that certain transaction dated November 13th, 1981 and that the Court make an order to this effect upon such terms as may be just and equitable.

THIRD CAUSE OF ACTION

1. Plaintiffs reallege in this Third Cause of Action all allegations made in the other Causes of Action as stated herein.

2. That defendants, Grant C. Affleck, Steve N. Olpin, Richard L. Gray, Home Savings and Loan, and Barclays American-Financial did offer or sell securities in violation of Section 61-1-22 Utah Code Antotated, (1953, as amended), to wit:

That the above defendants did sell a security to the plaintiffs in violation of the conditions imposed under Section 61-1-10 in that plaintiffs were not supplied with the prospectus concerning the offering prior to the consummation of the sale and also that the prospectus which was furnished after the consummation of the sale did not contain all of the disclosures required under Utah law including but not limited to the following omissions:

a. The general character of the business conducted by AFCO Enterprises, Inc..

b. A general description of the competitive conditions in the market in which AFCO Enterprises, Inc., was engaged.

c. The name, address, and occupation for the past five years of every director and officer of AFCO Enterprises, Inc..

d. Whether or not any securities are held by any director or officer of AFCO Enterprises, Inc. as of a specified date.

e. Whether or not any director or officer of AFCO Enterprises, Inc., is the owner of a material interest and has participated in a material transaction within the last three years.

f. The remuneration of officers and directors of AFCO Enterprises, Inc., during the last twelve months and a projection for the next twelve months.

Tab 4

Federal Home Loan Bank Board
Office of Examinations and Supervision
REPORT OF EXAMINATION

NAME AND ADDRESS OF INSTITUTION	DISTRICT NO.	DOCKET NO.
Home Savings and Loan 116 South Main Street Salt Lake City, Utah 84101	12	7772
	EXAMINATION AS OF June 4, 1982	

Federal Home Loan Bank Board

Gentlemen:

As required by the Rules and Regulations for Insurance of Accounts, we have conducted an examination of the above-named institution as of the date shown above and submit herewith the results of our findings.

Information contained in the supporting schedules of this report is from the institution's books and records. The examiner's comments and conclusions are based on an analysis of information obtained from the institution's records and from other authoritative sources. This report has been prepared for supervisory purposes only and should not be considered an audit report.

The following comments summarize, when applicable, conditions, policies, practices and trends which have had or may have an adverse effect on the institution's financial condition. Other major items of concern, not necessarily related to financial condition, are also summarized.

Examiner-in-Charge
State of Utah

Examiner-in-Charge
Federal Home Loan Bank Board

REPORT SUMMARY

The institution's lending procedures have resulted in high scheduled items, possible losses, potential real estate owned and lawsuits.

The lack of consistent procedures has caused 41 second trust deed loans referred to the institution by AFCO to become the subject of lawsuits between the borrowers and Home Savings. None of the borrowers are making payments, the loans are scheduled items and the institution has commenced foreclosure.

Similarly, the absence of sound procedures and lack of supervision of loan department personnel has resulted in a large construction loan that is $425,000 short of funds to complete and the possibility that the institution will have to acquire title, complete, and market the 40-unit condominium.

EXHIBIT
176

Docket No. 7772

COMMENTS

A. SECOND MORTGAGE LOANS

By deviating from normal loan processing procedures, management has subjected the institution to high scheduled items ratios, lawsuits and possible losses.

1. Introduction

At the examination date, scheduled items totaled $1,448,894 representing 6.82 percent of the institution's assets. Slow loans account for $1,223,662 and 5.76 percent of these totals. Included in this figure are 41 loans aggregating $888,998 which are second mortgage loans initiated by a firm known as AFCO. These loans represent a potential for losses and/or large legal expenses to the institution.

2. Background

Approximately 285 unhappy investors filed a $50 million lawsuit on April 7, 1982, against a real estate developer, Grant Affleck and several financial institutions, including Home Savings and Loan, Salt Lake City, Utah. Also named as defendants were two employees of Home Savings and Loan, William H. Cox and Larry Glad, neither of whom are still employed by Home Savings.

At the preceding exam, Mr. Cox was the vice president in charge of lending. The plaintiffs are investors in corporate entities (known as AFCO) controlled by Grant Affleck. AFCO is a developer of a condo time-sharing development known as Sherwood Hills, located near Logan, Utah. On March 8, 1982, AFCO filed for bankruptcy.

the Affs Scheme ≠ Glad's creation

The complaint alleges that the defendants solicited the plaintiffs to buy an investment package that required the investor to execute and deliver a promissory note payable to a funding institution (i.e., Home Savings and Loan). These promissory notes were in most instances secured by a second mortgage on the plaintiffs' personal residences (an equity loan). Proceeds of the loans flowed to AFCO. In return for the funds, AFCO executed and delivered a promissory note to the plaintiffs, which notes were purportedly secured by liens on property owned by AFCO (including Sherwood Hills). From the sales of the time-share condo's at Sherwood Hills, AFCO was to make the payments to the funding institution on the equity loans taken out by the plaintiffs.

The complaint alleges that the funding institutions, in addition to participating in numerous misrepresentations, departed from conventional and standard lending practices, namely, that the funding institution:

- Expedited the completion of the loan transaction to meet the demands and purpose of AFCO.
- Accepted from AFCO, financial and credit data on plaintiffs without confirmation from plaintiffs.
- Authorized and permitted AFCO to solicit and arrange the loans on behalf of the funding institutions.
- Failed to provide plaintiffs an adequate opportunity to rescind.
- Agreed to rely on AFCO credit for repayment of the loans.
- Were joint venturers or partners with AFCO.

Essentially the plaintiffs want all the equity loans made by the funding institutions to be voided or set aside, and to return the promissory notes executed by AFCO. In addition, they seek to recover treble damages and reasonable attorneys fees from the defendants, jointly and severally, estimated to be no less than $50 million.

ml

A. SECOND MORTGAGE LOANS

2. Background (continued)

Home Savings and Loan granted 41 loans totaling approximately $1,250,000 to the plaintiffs, of which 23 totaling $743,850 were sold to Rocky Mountain Federal Savings and Loan Association, Cheyenne, Wyoming, and a 95 percent interest in 14 loans totaling $456,400 to First Federal Savings and Loan Association of Great Falls, Montana. Rocky Mountain has demanded that Home repurchase the loans on the basis that the loans were in default at the time of sale. Home has repurchased the loans from Rocky Mountain Federal Savings and Loan Association.

3. Current Legal Status

The various lenders named in the lawsuit answered the complaint and requested removal of the loans from the bankruptcy proceedings. On June 22, 1982, the court removed the loans from the AFCO bankruptcy thus permitting Home Savings to proceed with foreclosure. Because none of the borrowers had made payments, the institution had already commenced proceedings by filing for judicial foreclosure on June 18, 1982. The decision to file for judicial foreclosure rather than the usual trustee foreclosure was taken on advice of legal counsel. The judicial foreclosure proceedings normally take 6 months and according to Manager Howard Bradshaw, cannot be interrupted by another lawsuit as may a trustee sale.

At the close of the examination, none of the borrowers had responded to the summons nor had any payments been received on any of the loans.

Management expects that there will be further attempts to frustrate the foreclosures by challenging the validity of the documentation and underwriting.

4. Affect on Operations

Because no payments have been received, the delinquent interest has had to be reserved. At the examination date, management had established an $85,000 reserve for uncollected interest on the loans. At June 30, 1982, this had increased to $98,000. The operating loss through May 31 was $67,402 and through June 30 was $64,392. Thus the lack of income from these loans places the institution in a position of an operating loss for the semiannual period, the first period to show an operating loss since acquiring insurance of accounts.

5. Procedures and Documentation

On November 10, 1981, Home Savings entered into an agreement with AFCO whereby AFCO would refer homeowners to the institution for second trust deed loans. Home Savings would loan AFCO $100,000 secured by junior deeds of trust on five condominium units and an office building. When $500,000 of the second trust deed loans had been granted by Home Savings, AFCO would pay $50,000 on the $100,000 loan and from that point, would further reduce the principal by 10 percent of all additional second trust deed loans Home Savings granted to borrowers referred by AFCO.

Other documents indicate that the applicants would have to meet Home Savings' normal lending criteria and the loans would be granted subject to their being able to be sold on the secondary market.

However, the processing of these loans was handled in a manner inconsistent with the institution's normal processing procedures.

The application was provided to the borrower by AFCO and, when completed, was submitted to Home Savings by AFCO. After being approved by Home Savings' loan committee, the loan documents were prepared and given to AFCO. Personnel from AFCO then closed the loans at the borrowers' residence. The notary public purportedly witnessing the signatures was an employee of AFCO who, according to some borrowers, was not present at the closing and did not see the borrowers at any time.

SECOND MORTGAGE LOANS

5. Procedures and Documentation (continued)

Catherine Godbe, the vice president currently in charge of the association's loan department, stated that she had reviewed all of the files and each borrower had qualified under the association underwriting guidelines, regarding payment to income ratio, loan to appraised value ratios and credit history.

In a complaint, one borrower claimed that the documents were dated 7 days prior to the actual signing. When he attempted to rescind the transaction, he was told that the rescission period had expired. A review of the documents indicates this contention may have validity based on the following:

- A letter written by Grant C. Affleck to Executive Vice President Fred Smolka at Home Savings states in part,

T-Ex 20

"Dear Mr. Smolka:

"Please be advised that under the direction of your loan officer the documents that the individuals signed on Afco's referred 2nd mortgage loans were consumated as follows:

1. *The right of recision was waived - all documents were back dated.*

2. *I was personally instructed to take the documents to the closings to the individuals homes for the closings - without any loan officer or employee of Home Savings & Loan."*

- The deed of trust was dated December 21, 1981, but was not recorded until January 6, 1982.

- The check for the loan proceeds was dated December 24, 1981. The borrower endorsed the check back to Home Savings but it was not paid by the bank until January 5, 1982.

- The rescission notice stated that the rescission period expired at midnight December 24, 1981, but the check had already been issued according to the way it was dated. There was no evidence of the customer waiving his rescission rights because of an emergency.

Home Savings President Bradshaw stated that three individuals did request rescission and their loans were cancelled. He further stated that Home Savings' position is strong based on several reasons:

T-Exs 81 & 90

- Each borrower signed a statement wherein they acknowledge that they are responsible for the loan payments and that Home Savings does not have any connection with any decision they make as to the loan proceeds.

- Each borrower signed a receipt for the notice of the right to rescind.

- The title company has indicated it will not invalidate coverage because of any notary irregularities.

- Home Savings' attorney is of the opinion that AFCO was the agent for the borrowers, not the institution.

- MGIC is insuring 100 percent of the loans sold to First Federal Savings of Great Falls, and 15 percent of the other loans.

SECOND MORTGAGE LOANS

5. Procedures and Documentation (continued)

At the conclusion of the examination, U. S. District Court Judge Edwin Mecham took under advisement a motion to prevent foreclosure action by all financial institutions involved in the AFCO controversy. In addition, eight borrowers filed a lawsuit against Home Savings and Loan and Carvel R. Shaffer, a lawyer and director of AFCO. The suit charges that employees of Home Savings falsely and intentionally back-dated certain documents, represented the transactions to be sound and prudent investments, and notarized certain documents without plaintiffs being present.

6. Contingent Liability - Lawsuit

The above-mentioned second trust deeds initiated by AFCO also resulted in a lawsuit being filed against the institution.

Grant Affleck contacted one Ronald W. Haslam and asked him for a short-term loan of $65,000. He informed Mr. Haslam that Home Savings was processing some second trust deed loans which would be used to repay Mr. Haslam and invited Mr. Haslam to confirm the information with Home Savings. Mr. Haslam telephoned Home Savings' loan department and spoke with Larry Glad, a loan solicitor for the institution. Mr. Glad verbally attested to the correctness of Mr. Affleck's statement. Mr. Haslam asked for written confirmation and received a letter on Home Savings' letterhead dated November 27, 1981, which stated:

"Please be advised that Afco Enterprises, Inc. is processing second mortgage loans through Home Savings and Loan. We presently have completed approval on a second mortgage package for $250,000.00. Mr. Grant C. Affleck, Chief Executive Officer of Afco Enterprises, Inc. has authorized Home Savings and Loan to hold $65,000 in checks on the forementioned commitment to be disbursed directly to you on or before December 10, 1981.

"Any questions, call me directly."

The letter was signed by Larry Glad.

On November 27, 1981, Mr. Haslam borrowed $65,000 from a local bank to be repaid by May 26, 1982, and gave the funds to Affleck. As he did not receive the funds from Home Savings, he telephoned Home Savings to inquire why he had not been paid the $65,000 that had been held from the proceeds of the second trust deed loans. When he was informed that no funds were being held for him, he filed suit for reimbursement.

In a reply to the lawsuit, the institution bases its defense on Larry Glad being an *"independent contractor who solicited loans and processed applications for loans"* for Home Savings. Also that Mr. Haslam *"had no reasonable basis to rely on any such representations made by Larry Glad"* and should have checked with corporate officers as to whether he had authority to make such representations.

Home Savings further states that Larry Glad and Grant Affleck conspired to subject Home Savings to the liability and should be held responsible for any liability.

B. CONSTRUCTION LOAN - POTENTIAL REAL ESTATE OWNED

Management's loan underwriting and disbursement procedures have resulted in a large construction loan having insufficient funds to complete construction and the prospect of the institution acquiring title to the property expending $425,000 to complete the project.

The institution granted a $900,000 loan to T.H.P. Co. on January 12, 1981, based on a Veterans Administration appraisal and Certificate of Reasonable Value of $1,680,000. The security property when completed was to be a 40-unit condominium project.

CONSTRUCTION LOAN - POTENTIAL REAL ESTATE OWNED (continued)

The commitment for the loan indicated that the loan amount could be increased to $1,260,000 based on savings growth as approved by the board of directors. Former Vice President William Cox made inspections and disbursed funds based on the anticipated increase in the loan amount. However, no increase took place. Sometime in October 1981, faced with a shortage of funds and no sales, the developer ceased work on the project. The construction loan matured June 22, 1982.

Home Savings did not commence foreclosure action permitted by its construction loan agreement when construction ceased because their legal counsel was not satisfied with the completed agreement. He suggested that the institution wait until the loan matured at June 22, 1982.

Home Savings did continue to charge interest to the loans in process account (LIP) as provided in the construction loan agreement after the construction ceased in October 1981. This agreement provided that if interest was not paid when due, after 10 days, the interest could be charged to LIP. Based on disbursements from the LIP, the project was doomed to failure at the start without additional loan funds.

The first two disbursements from LIP included a $75,718 payment on the land with the owner, Phillips S. Mobey, taking a second lien for the remainder of his equity. The second disbursement was $73,500 for loan fees of which $31,500 was for the construction loan and $42,000 for a $1,680,000 permanent loan takeout commitment. In addition, as the construction proceeded, monthly interest was charged against the LIP account, and taken into income. This interest by semiannual periods was:

January 12, 1981 to June 30, 1981	$ 40,725
July 1, 1981 to December 31, 1981	78,505
January 1, 1982 to June 30, 1982	78,370
Total	$197,600

It is the examiner's conclusion that at least $115,779 of this interest (October 1981 to June 1982) should not have been taken into income, but placed in a reserve for uncollected interest. This is because construction ceased; the loan was in default with little or no prospect of the project being completed by the borrowers and the LIP balance was insufficient to complete construction.

Based on the above described disbursements, only $553,182 (or $13,830 per unit) was available to construct the 40 units. The original appraisal assigned an individual cost per unit of $30,955 plus $11,250 for the land. This estimate of construction funds available was based on:

Loan Balance	$900,000
Less: Land Payment	75,718
Loan Fees	73,500
Construction Interest	197,600
Balance	$553,182

A mortgage equity discounted cash flow analysis, using current market rates, for these units was made based on the following information furnished by Home Savings' President Howard Bradshaw:

No. of Unreleased Condo Units	40
Per Unit Estimated Sales Price	$ 38,000
Selling Period	6 Months
Holding Costs	100,000
Marketing Costs	50,000
Interest Rate on the Loan	14%
Equity Rate for Borrower	20%
Funds Needed to Complete Units and Common Areas	425,000
Service Charge (including 3% service charge on $425,000 advance)	85,750

CONSTRUCTION LOAN - POTENTIAL REAL ESTATE OWNED (continued)

Present Book Value	$ 900,000
Advance	425,000
Total Advance	$1,325,000
Equity (Based on Computer Program)	$ (427,466)
Value	$ 897,534

Loan to Value Ratio 147%.

In addition, the value of the units, if completed and rented as apartments, is estimated to be as follows:

40 Units @ $350 per month for a Year	$ 168,000
5% Vacancy Factor	8,400
Net Estimated Rental Income	$ 159,600
Less: 35% Expenses	$ 55,860
Net Income	$ 103,740
Value Using a 10% Recapture Rate	1,037,400
Appraised Loss (Estimated)	$ 287,600

As mentioned previously, $42,000 was paid out of the loan funds for a $1,680,000, 20-month permanent loan commitment. Based on Section 563.23-1 (g)(4)(ii) of the Insurance Regulations, $33,600 of the fee was eligible to be taken into income and $8,400 to be deferred. The $42,000 has been taken into income.

At the close of the examination, a property inspection of the project was made by the examiner and Home Savings' President Howard Bradshaw, who is a member of the Society of Real Estate Appraisers. President Bradshaw estimated the stage of completion for the units ranged from 37 to 90 percent. He further indicated the common areas, yet to be completed, consisted of a 17' X 42' swimming pool, fencing, asphalt roads and parking and landscaping. He estimated a total cost of $425,000, but was waiting for actual bids from several contractors.

On July 18, 1982, T.C.P. issued a deed in lieu of foreclosure on the property to Home Savings. Home Savings has not accepted the deed at present as they desire an additional protection clause in the deed. Once the deed is accepted and recorded, the institution plans, according to President Bradshaw, to accept the best bid, complete the units, and offer them for sale at rock-bottom prices, thereby avoiding any loss.

A title report on the security property dated July 27, 1982, indicated the only lien on the property was the institution's $900,000 loan. But the report did indicate that title to Unit "D" in building two was in the name of Phillip S. Maybe. This could add an additional problem as no funds have been paid to Home Savings to release this unit.

C. LOAN INVOLVING AFFILIATED PERSON

Institution President Howard C. Bradshaw received funds from the proceeds of a third trust deed loan granted to a third party. This is in noncompliance with Section 7-7-15(c) of the Utah Financial Institution's Act of 1981 and also has the appearance of a conflict of interest.

LOAN INVOLVING AFFILIATED PERSON (continued)

In an addendum to his original response to Question 7 of the Management Questionnaire, Mr. Bradshaw identifies a transaction wherein he received a portion of the loan proceeds. Additional details include:

- The appraisal of $189,000 was prepared by Mr. Bradshaw.
- The loan was approved by Mr. Bradshaw and Executive Vice President Smolka. The State Act requires a board resolution approved by two-thirds of the directors with the interested director having no part of the vote, for approval of the loan.

D. APPRAISAL PRACTICES

The institution's appraisal practices for major loans are considered deficient because the institution does not retain control of this function.

1. Unapproved Appraisers

Loan 500371 granted to Roy Dental Clinic is supported by an appraisal prepared by Louis Howard. Also loan 500393 granted to Butler, Crockett and Walsh had an appraisal prepared by Thomas Heal. Neither Mr. Howard nor Mr. Heal is included on the list of appraisers approved by the board of directors.

2. Appraisals Not Prepared for Lender

The above appraisal reports by unapproved appraisers were addressed to the borrowers and prepared for their use. Additionally, the appraisal supporting loan 500391 granted to Clark and Green was prepared for Franklin Financial, a former owner and seller of the property. Moreover, this appraisal was for 100 acres of land. Only 50 acres of the land was purchased by Clark and Green and used as security for the institution's loan.

Mr. Bradshaw offered no explanation for the above practice but agreed that all such appraisals should be addressed to the institution and prepared by approved appraisers.

E. LIQUIDITY RECORDS

Contrary to the provisions of Bank System Regulation 523.13(b), the institution did not have liquidity records for part of the review period.

The review of liquidity disclosed that no records were available for the months of July, October and November 1981, or January and February 1982. The examiner did not attempt to reconstruct liquidity records for those months. Management was requested to prepare the records and to furnish the Supervisory Agent with the average monthly liquidity percentages for the months in question. Forty-five days were allowed in which to accomplish this.

LOAN UNDERWRITING STANDARDS

The review of the minutes did not disclose an annual review of the above standards by the board of directors. Bank System Regulation 528.2a(b) requires such an annual review.

Mr. Bradshaw stated the review would be included on the agenda of the next board of directors' meeting and it would be reviewed annually thereafter.

ELECTRONIC DATA PROCESSING

1. Contract

The institution does not have a contract with DHI, Inc., its data processor, a condition existing since before the preceding examination.

Controller Gerald Hunter stated that DHI had presented a contract to Home Savings but it was unsatisfactory and was rejected by the users. He stated that the attorney for Western Savings (another user) was preparing a contract that would meet the needs and requirements of the users and when completed and accepted it would be implemented by all the users including Home Savings.

2. Supervisory Keys

The institution has not implemented a program to control the use of the supervisory holds placed on various accounts.

The window posting machines used by the tellers have provision for a supervisory key by which holds may be placed or released on various accounts. This key is not controlled and tellers have unrestricted access to its use. A compensating control is the "Exception Report" detailing the transactions requiring the use of the key. Thus management can determine the propriety of the transactions by review of the report. Home Savings does not receive such reports from DHI therefore has not developed a compensating control for the unrestricted teller access to the supervisory key.

Mr. Bradshaw stated that DHI would be requested to provide exception reports for management review.

H. ELECTRONIC FUNDS TRANSFERS (REGULATION E)

Home Savings is not complying with the disclosure requirements of Section 205.7 of Regulation E.

The institution accepts direct deposits for customers from the Social Security Administration and other transfer-payment programs. When such an account is set up, the disclosures required by the above noted section are not made. Thus the customer is not aware of whether notification will be made when such payments are received, or only if they are not received. Nor are they provided with a telephone number where inquiries may be made, and the business hours such inquiries may be made. Similarly, they have no information on what to do in case of errors or the institution's error resolution procedures.

Mr. Bradshaw stated he was not aware of the requirement for disclosure but promised to implement the required disclosures.

I. MONITORING INFORMATION

The monitoring information for race and sex required by Bank System Regulation 528.6 and Regulation B was not disclosed nor designated by the lender on four of ten applications reviewed to determine compliance.

Mr. Bradshaw stated that loan personnel would be instructed to obtain the information on all applications.

J. EQUAL EMPLOYMENT OPPORTUNITY

Home Savings is not in compliance with Bank System Regulation 563.36 regarding Equal Employment Opportunity as follows:

- The home office did not display the notice relating to equal employment opportunity required by subsection (b)(3) of the regulation.
- Advertisements for employment did not include the statement that Home Savings was an Equal Opportunity Employer. Subsection (b)(4) requires such a statement.

Tab 5

DECEMBER 1, 1981

Home Savings and Loan
130 East 3300 South
Salt Lake City, UT 84115

100069

Gentlemen:

This letter is written to acknowledge that we have applied to Home Savings and Loan for a loan to be secured by a second trust deed on our personal residence in the amount of $ 14,500.00, which funds we intend to use for purposes of "investment". Although we have been referred to Home Savings and Loan by AFCO Enterprises for this purpose, we acknowledge that Home Savings and Loan has in no manner been involved in any negotiations between ourselves and AFCO Enterprises nor has Home Savings and Loan been involved in any manner in our decision as to how to use or invest the proceeds of such second trust deed.

We acknowledge that we are fully responsible for full payment of the note secured by such trust deed and each installment thereof in accordance with the terms of said note.

We agree that the loan from Home to us has been documented conditionally and contingent upon a subsequent secondary-market approval. Until such approval be obtained, Home reserves the right to reject the loan.

We further acknowledge that we are aware that AFCO Enterprises may separately arrange to borrow funds from Home Savings and Loan for AFCO Enterprises' account.

Very truly yours,

X Victor W. Armitage
VICTOR W. ARMITAGE

X Marilyn H. Armitage
MARILYN H. ARMITAGE

STATE OF UTAH)
: ss.
COUNTY OF SALT LAKE)

On the 1st day of December, 1981, personally appeared before me Victor W Armitage and Marilyn H Armitage the signers of the above instrument, who duly acknowledged to me that they executed the same.

Valerie Kosta
Notary Public residing at
Salt Lake County

My Commission Expires:
May 4, 1984

EXHIBIT
89

EXHIBIT

90

NOVEMBER 19, 1981

100618

Home Savings and Loan
130 East 3300 South
Salt Lake City, UT 84115

Gentlemen:

This letter is written to acknowledge that we have applied to Home Savings and Loan for a loan to be secured by a second trust deed on our personal residence in the amount of $ 22,350.00, which funds we intend to use for purposes of "investment". Although we have been referred to Home Savings and Loan by AFCO Enterprises for this purpose, we acknowledge that Home Savings and Loan has in no manner been involved in any negotiations between ourselves and AFCO Enterprises nor has Home Savings and Loan been involved in any manner in our decision as to how to use or invest the proceeds of such second trust deed.

We acknowledge that we are fully responsible for full payment of the note secured by such trust deed and each installment thereof in accordance with the terms of said note.

We further acknowledge that we are aware that AFCO Enterprises may separately arrange to borrow funds from Home Savings and Loan for AFCO Enterprises' account.

Very truly yours,

Neil D. Fuse

Carol June Fuse

STATE OF UTAH)
: ss.
COUNTY OF SALT LAKE)

On the 19th day of November, 1981, personally appeared before me Neil D. Fuse and Carol June Fuse the signers of the above instrument, who duly acknowledged to me that they executed the same.

Valerie A. Costa
Notary Public residing at
Salt Lake County

My Commission Expires:
May 4, 1982

Tab 6

BENCH, Presiding Judge (dissenting):

The majority holds that there is a distinction between the phrase "discovery of loss" as it is used to determine coverage and "discovery of loss" as it used to trigger notice requirements. The majority thereby adopts a minority, if not a totally novel, interpretation of discovery bonds and demands a significant departure from current industry practices. I believe that, under the terms of the bond, Aetna is not liable to Home for any loss resulting from the dishonesty of Glad or the Armitage lawsuit. Any coverage for the loss arising from the Armitage lawsuit must be found under the F&D bond, not the Aetna bond. Home is simply seeking recovery from the wrong insurer. I therefore respectfully dissent.

The loss was not discovered during Aetna's bond period for any one of three reasons: (1) Rider 6091 expressly provides that discovery includes potential losses; (2) even without the rider, a loss arising from liability created by the dishonesty of an employee may be discovered when the employee's dishonest conduct is discovered, though the liability has not yet been adjudicated; and, (3) under the majority's own rule that a loss may not be discovered until it is sustained, the Armitage loss could not have been discovered during the bond period because it was not sustained until after the effective period of the bond.

The loss also was not covered because it fell within the exclusion found in Section 11 of the bond. Section 11 excludes from coverage all employees previously known to have committed a dishonest act.

Home also should be barred from seeking recovery for any damages resulting from the Armitage lawsuit because it did not, as required by statute, disclose in its application the pending Armitage claim, a material fact regarding the hazard assumed by Aetna.

In view of the foregoing arguments, any one of which should be dispositive, I dissent without opinion as to the other issues addressed by the majority with the exception of the offset issue. Even if the loss were covered by the bond, the majority errs in not remanding this case for consideration of the offset of damages issue since the parties had expressly reserved the issue of damages for determination by the trial court rather than the jury. Damages simply may not be determined without addressing any claimed offset.